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Attracting investments to Ukraine's gas transport system

The creation of a gas consortium including Ukraine, Russia, and a gas-consuming European country has been announced. ICPS experts believe that this move is the only way to resolve the problem of attracting investments into the modernisation of Ukraine's gas transport system. The pros and cons of existing alternatives have been evaluated in issue No. 21 of the Quarterly Predictions journal (October 2002)

The gas transport system (GTS) is Ukraine's biggest asset. According to an INOGATE[1] estimate, its value amounts to 13.8 billion USD, which outstrips the value of other big Ukrainian companies. Nevertheless, maintenance and upgrade of such an immense system requires money. According to an estimate made by former Deputy Prime Minister for Energy of Ukraine, Yulia Tymoshenko, the demand for funds for maintenance, replacement of outdated equipment, upgrading, and boosting GTS capacities amounts to 350–500 million USD annually. In accordance with the National Program "Ukraine's Oil and Gas till 2010", investment volumes in the reconstruction and development of the GTS approximate 270 million USD annually.

Policy options for attracting investment in the GTS are the following:

• financing investments from the profits of the Naftogaz Ukrainy National Joint-Stock Company;

• financing investments from budget funds;

• borrowing in external capital markets;

• domestic borrowing;

• launching joint projects with EU countries;

• establishment of a consortium for GTS management involving Ukraine, Russia, and a European country which consumes Russian gas;

• assigning the GTS as a concession;

• GTS privatisation through sale.

[1] INOGATE (Interstate Oil and Gas Transport to Europe) is an international organisation financed by the European Union. INOGATE's mission is to enhance the safety of gas supply to Europe.

The specified options are listed above in the order of decreased control over the GTS by the Ukrainian party. All other terms being equal, control by the Ukrainian party over the GTS allows Ukraine to take maximum advantage of the GTS. Specifically, this applies to the revenues from the transit of gas from various sources and storing it in underground gasholders. An investor that gains control over the GTS would independently make decisions about the types of services and prices to serve its own interests. If the investor seeks to add value to the GTS (and, hence, the value of its own company), then its behaviour will be focussed on increasing revenues from GTS services, which will suit Ukrainian interests and bring more revenues to the budget. The chances are stronger that such an investor would be selected if open concession or privatisation bids were held. The pros and cons of each option are furnished in the Table 1.

The GTS management consortium involving the Naftogaz Ukrainy National Joint-Stock Company, the Gazprom (Russian) Joint-Stock Company, and a representative of a European consumer means, in fact, the loss of some control over the GTS. The consortium creates the following risks for Ukraine:

• Consortium members have conflicting interests: (1) Ukraine is interested in enlarging its income from gas transit (specifically, by augmenting gas transit fees) and diversifying gas suppliers; (2) on the European side, the gas-consuming country is interested in reducing the price, as well as diversifying suppliers; and (3) on the Russian side, Gazprom is interested in cutting the transit price and in monopolising the gas supply market. Given such a divergence of interests, it is hardly possible to establish governance mechanisms which could ensure the equality of the parties, while allowing the approval and implementation of effective decisions. Furthermore, Gazprom and the gas-consuming country could unite against Ukraine in order to curtail the gas transit price, which would bring losses upon the Ukrainian party. This risk could be warded off only if all parties strictly observe the Transit Protocol—although this protocol has not been signed yet, and Russia opposes its key points;[2]

• The Gazprom Joint-Stock Company seeks to retain its monopoly, which can limit Ukraine's possibilities to use its transit potential, particularly, in transporting gas from Central Asian countries and providing storage services;

• It is possible that the contract terms for attracting expected investment volumes to upgrade the GTS will not be fulfilled, in view of the need of the Russian Gazprom to invest in the exploration of new gas deposits, which will consume sizable capital investments;

• Risks to the supply of domestic consumers with gas. The arterial pipelines are also used to deliver gas to domestic consumers, but the interests of Ukrainian consumers can turn out to be of low priority for the consortium.

Therefore, we believe that without proper legislation, the loss of Ukraine's control over the GTS may entail sizable risks. Simultaneously, the option of

[2] The aim of the Protocol is to determine a set of consistent legal principles regulating electricity and gas transit. The key protocol requirements include the following: (1) preventing non-sanctioned expropriation of transported resources; (2) guarantee of non-discriminatory access to the existing transit infrastructure; (3) transparent criteria for transit tariff setting; and (4) determining procedures for dispute settlement.

borrowing in capital markets is costly, in view of the loan cost reflecting the high investment risks in Ukraine.

Therefore, we consider the most suitable options of those specified to be the following: (1) financing investment in the GTS from the corporate funds of the Naftogaz Ukrainy National Joint-Stock Company; and (2) launching joint projects with the EU.

Financing investment in the GTS with the corporate money of the Naftogaz Ukrainy National Joint-Stock Company demands measures to mend its financial position, namely:

• timely budget settlements with the Naftogaz Ukrainy National Joint-Stock Company for subsidies (discounts) granted to citizens and consumed services of budget-sector organisations;

• implementation of tariff calculation methods for gas supply that would take into account the cost of capital;

• channeling the money from the gas transit payments deducted to the budget by Naftogaz Ukrainy towards investment in the GTS. The 2002 budget envisages that Naftogaz Ukrainy should transfer 2.24 billion UAH (420 million USD), which is approximately equal to the above assessment of the need for investment.

The impetus for implementation of joint Ukraine–EU projects is the European Commission document on "The external dimension of Trans-European energy networks" dated 26 March 1997. This document lists projects in which the EU and neighbour countries have common interests. (In particular, the increasing demand for gas in the EU will boost the demand for gas storage services). This list includes eight investment projects for the pipeline system in Eastern European countries, in particular, a project to upgrade gas pipelines in Ukraine, Slovakia, and the Czech Republic.

EU enlargement and assigning "neighbour" status to Ukraine is a unique opportunity to invigorate negotiations regarding joint projects in the gas sphere. EU candidate countries have an interest in ensuring the security of Ukraine's gas-transport system. In case of accession to EU, these countries will have an opportunity to lobby EU institutions for joint projects with Ukraine. The outcome of joint Ukraine–EU projects should be Ukrainian GTS security standards adjusted to the European ones.■

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Table 1. Options for attracting investments to Ukraine's GTS

Option	Pros	Cons
Financing from the profits of the Naftogaz Ukrainy National Joint-Stock Company	Control over the GTS by the Ukrainian party, and, hence, maximum benefits from GTS usage for Ukraine	Requires the abolishment of budget deductions from gas transit payments, which would mean roughly 2 billion UAH annual losses from the budget
Financing from budget funds	Control over the GTS by the Ukrainian party	Money engaged in financing other budget programs would need to be withdrawn, which may prove politically difficult
Borrowing in the domestic capital market	Control over the GTS; and a development impetus for the domestic capital market and impedance to capital outflows	High cost of borrowing, given the high risk of the government's failure to execute obligations
Loans obtained in the external capital markets	Control over the GTS	High cost of borrowing, and thus, increased budget spending
Launching joint projects with the EU	Control over the GTS; and attracting investments to harmonise the GTS with European standards	Difficulty of implementation, since it demands the fulfillment of EU procedures for project justification, while the Ukrainian government's capacity for this is low
Establishment of a management consortium, involving the Russian Gazprom Joint-Stock Company	Ease of establishment, since there is political consent of the parties	Difficulty of establishing a management mechanism that would ensure equality of the parties; risks of failure to execute obligations by parties; and lack of relevant legislation
Granting the GTS as a concession	Legislation exists that envisages selection of a concessionaire through bidding; and budget revenues from concession fees	Risks of the investor's failure to execute obligations; risks of corruption; and partial loss of control
GTS privatisation through sale	A procedure exists for selecting a buyer through a privatisation contest; and additional budget revenues	Complete loss of control over the GTS; and risks of the investor's failure to execute obligations

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